Section 2 Monetary and Financial Policy

1 Financial Liberalization and Internationalization, and the "Bubble Economy"

The Easy Money Policy after the Plaza Accord In September 1985, the G5 countries confirmed the agreement on a concerted intervention to correct the dollar depreciation against the Japanese yen and German mark, the implementation of the domestic demand expansion measures in these countries, and the correction of the balance of payments imbalance through these measures (The "Plaza Accord"). The Japanese government also acknowledged that domestic demand should be improved to reduce the surplus, in order to avoid an anxiety that the yen appreciation would advance given the background of current account surplus, and that it would cause severe damage to export related industries. The domestic demand expansion measures were then decided upon by the Ministerial Conference for Economic Measures.

If the fiscal policy was not executed to expand domestic demand because it was in the process of fiscal reconstruction, the easy money policy would entirely play the role. A policy mixture of strained public finance and monetary easing would be effective to cut the interest rate, promote the capital outflow (yen selling/dollar buying) and lead to dollar appreciation and yen depreciation. It would even be a reason to increase imports and decrease the exports of Japan, and increase the current surplus. Immediately after the Plaza Accord, the Bank of Japan was concerned about such matters as the decline of interest rate, the expansion of the interest spread between Japan and the U.S., and action for yen depreciation. The yen-dollar exchange rate was stabilized at ¥215 per U.S. dollar in and after October, but the yield curve of interest rates at that time showed a negative yield, and the short term interest rate was higher than the long-term interest rate. That is, the BOJ made the short-term interest rate higher, to try to change their prediction that the expectation of decrease for the future interest rate in the market had been cause that had hindered the correction of yen depreciation.

However, as the end of the year was approaching, the U.S. interest rate decreased, leading to less anxiety about the expansion of international interest-spread, and the yen appreciation rapidly advanced; therefore people started to talk of a "Yen appreciation recession". Under these circumstances, the BOJ took clear easy money measures to cut the official discount rate continuously, in and after January 1986, as shown in Table 3-2-1. Finally, the official discount rate recorded 2.5%, which was the lowest level in history (as of) February 1987. This low interest rate was maintained until May 1989, and the bubble economy occurred and expanded in the meantime. (See Figure 5-8 of the

Introduction).

Table 3-2-1 Change in the Official Discount Rate
(FY1983-1991)

Year/Month/Date	%	Year/Month/Date	%
1983.10.22	5.00	1989. 5.31	3.25
1986. 1.30	4.50	10.11	3.75
3.10	4.00	12.25	4.25
4.21	3.50	1990. 3.20	5.25
11. 1	3.00	8.30	6.00
1987. 2.23	2.50	1991. 7. 1	5.50

Source: Bank of Japan, *Keizai Tokei Nenpo*, [Economic Statistics Annual] for each year.

The Start of the Bubble Economy. The sharp rise in land prices had already started in around 1983 in the commercial area in central Tokyo. This was because foreign financial institutions began to launch their businesses in Tokyo, one of the international financial centers and it was said that this had a background of real demand based on economic power. There were strong prospects for the Japanese economy because of the competitiveness and incomparable system, even if the trade surplus was criticized by foreign countries.

As shown in the Introduction, the “Yen Appreciation Recession” occurred in 1986, due to the surge of yen appreciation after the Plaza Accord, but a significant decrease in the prices of imported raw materials made a tremendous surplus of investment capital for Japanese companies to use. Then, fund management was booming, even creating the word “*Zaitech*”. In conjunction with the progressing rise of land and stock prices and the strong prospects of the economy, the aspects of a boom of speculation (Bubble Economy) became strong from around 1987. In particular, bank loans by real estate securities increased to excessively create money for transactions in assets, which was supported by the continuous easy money policy of the BOJ (affluent base money supplies).

The BOJ, though, had concerns about the increasing momentum of money supply, as in the saying “dry firewood piled up goes up in flames”: meaning that the “firewood” could soon be burnt up if it was ignited (by a blast of inflation). However, it was difficult to make monetary tightening policy since general prices were quite stable and the most important mission of the central bank was to stabilize prices. Therefore, the BOJ was under strong pressure to take responsibility for situation if they jeopardized the opportunity for epoch-making economic growth by a taking monetary tightening policy. Looking back, it was obvious that forward-looking (preemptive) tightening measures was necessary but it was quite difficult to apply such measure to the ongoing economy. The BOJ would have needed to oppose to the enthusiasm of the majority if they did so. It was even more difficult to make monetary tightening policy since prices were stable. There was a proposal for an “inflation targeting” scheme; that is, the risk of the bubble economy is high especially when prices are stable. Therefore, it might be argued that the price (inflation rate) should be made a uniform indicator, and made the stringent rule of the monetary policy, but it would also be important to consider the experience that coped with the above difficult problems.

The worldwide collapse in stock prices (“Black Monday”) which occurred in October 1987 also made monetary tightening policy difficult to take. This was because of the logic that Japan was not able to raise the interest rate, which was an anchor to stabilize the interest rates in the global market. In spring 1988, when the stock price turmoil had settled and the United States and Germany raised their interest rates, it was also an opportunity for Japan to make monetary tightening policy. However, the timing was missed and the official discount rate was raised after a year, in May 1989. The bubble economy was expanding rapidly during the period.

Monetary Tightening Policy and the Collapse of the Bubble Economy. Land prices did not fall for a while even when the Nikkei Stock Average started to decline from early January, after the peak of stock prices in the final session of 1989 at ¥38,915. The bullish expectations of the public remained unchanged and in a good mood, and substantial economic expansion also continued. However, the BOJ had togo ahead with its monetary tightening, and finally cut the official discount rate and eased the monetary policy in July 1991. It was too late to start monetary tightening, therefore, the policy became too hard and also the policy change came too late. The downward reaction caused by the collapse of the bubble economy was large and lasted long, so that the Japanese economy suffered from the negative effects for more than 10 years to follow.

The MOF then made guidance to financial institutions regarding land related loans as follows.

Financing had expanded due to aggressive lending for the real estate securities of the banks, which was one of the factors that triggered the bubble economy. Most of the loans at that time were mainly for the three industries including real estate, construction, and non-bank financial institutions (the loans eventually went to real estate related assets by way of non-bank). The MOF then controlled this type of loans by issuing the notification, "On the Handling of Land-related Loans" in July 1985, which was followed by continuous guidance which gradually made the more contents stringent. They requested banks not to encourage speculative land transactions at inappropriately high prices, or only for reselling. Moreover, a special hearing was also held referring to specific loan details after July 1987 but its effect did not appear. Therefore, the MOF proposed its strongest measures in the notification of March 1990 called the "*Sōryō Kisei*" (Quantitative restrictions on extension of real estate related loans), which was to request banks to control the increase rate of loans for real-estate industries, under the increase rate of the total amount of loans, as well as to request them to prepare a report on the loans for the above three industries. Although it was not legally compulsory, and even uncommon, because it intervened in the fund allocation of financial institutions, the last notification (*Sōryō Kisei*), contributed to stopping the bubble economy expansion, at that time, in conjunction with the monetary tightening policy of the BOJ that had already been executed.

2 Liberalization and the Increased Flexibility of Financial Regulations

The BIS Accounting Capital-adequacy Ratio. The Agreement of the "International Convergence of Capital Measurement and Capital Standard" (Basel Agreement) which was made in the Committee on Banking Regulations and Supervisory Practices (Cooke Committee) was approved by the BIS governor's meeting in July 1988.

The MOF recognized the background that this issue was raised for measures to deal with the risk for banks under the internationalization of financial markets, and intended to create fair competing conditions (specifically, to control the excessive presence of Japanese banks).

In January 1987, the U.S. and the U.K. joint proposal for unifying the restrictions based on the risk asset ratio were announced. It became the basis for discussions in the Cooke Committee. Japan then acknowledged that they should cooperate in the international agreement in general, so they decided to take the issue to G10 by making an agreement with the United States (and the U.K.), first of all. The process of coordination was to make each country compromise on their conditions for the final agreement of the standard ratio of 8% (the assumption of the United States was 10-12%). Another issue considered was the inclusion of appraisal profit to the equity capital (the U.S. and the U.K. insisted on non-inclusion, and Japan insisted on 70%). It was eventually settled at 45%. The agreement was made in the Cooke Committee in November 1987, and then agreed on the BIS, through consultations in each country in

July 1987.

It was recognized that the agreement included insufficient coverage of issues such as the risk assessment from the beginning and needed to be reconsidered. At this point, the MOF considered this was an opportunity for Japanese banks to shift their corporate management from “quantitative” to “qualitative” (expansion) but such intention had been swept away under the bubble economy.

The Shift to Financial Liberalization

The Liberalization of Interest Rates. In the field of interest rate liberalization, reduction of the minimum deposit (and eventually, the abolition of the limit) and expansion of the deposit term were progressed, based on the principle of “From a large lot deposit to a small one”. The easing of the NCD issue was also gradually advanced.

The year of 1985 was a time of big transition in terms of the interest rate liberalization, including the introduction of the “MMC (Money Market Certificate)” (March) and the interest rate liberalization of large-lot time deposits (October). Categories of deregulated interest rate products had been expanded gradually thereafter. From 1989, liberalization of small sum deposits began, while the interest rate liberalization ended due to the liberalization of the liquid deposit interests in 1994, which was followed by the abolition of the time limitation in the following year. It eventually took about ten years (15 years from the launch of NCD in 1979).

Entry, Exit and Merger of Banks. The number of financial institutions in this period changed, as shown in Table 3-2-2.

City banks decreased to 11 with the merger of the Mitsui Bank and Taiyo Kobe Bank on April 1, 1990 (the name of the bank was changed to the “Sakura Bank” from the Taiyo Kobe Mitsui Bank) while it had been 12 for a long time. This was the beginning of the movement toward integration of the major banks that happened after the collapse of the bubble economy.

The number of banks - 1 foreign exchange bank, 3 long-term credit banks, 7 trust banks and 64 regional banks - remained unchanged, but 5 cooperative banks decreased in this period, while the number of credit cooperatives started to decrease suddenly from 1988, by 41.

The biggest change occurred for mutual banks. With the reduction of 1 bank (merger of the Heiwa Sogo and Sumitomo Bank), the number became 68. Then most of the mutual banks were changed to ordinary banks as member banks of the Second Association of Regional Banks (Regional Banks II).

Table 3-2-2 Number of Financial Institutions

Year End	1985	1986	1987	1988	1989	1990
City bank	12	12	12	12	12	11
Foreign exchange bank	1	1	1	1	1	1
Long-term credit bank	3	3	3	3	3	3
Trust bank	7	7	7	7	7	7
Regional bank	64	64	64	64	64	64
Mutual bank (Sōgo Bank)	69	68	68	68	68	68
Cooperative bank (Shinkin Bank)	456	455	455	455	454	451
Credit cooperative	448	446	443	419	414	407

Source : Bank of Japan, *Keizai Tokei Nenpo*, [Economic Statistics Annual] 1992
Note : Since 1989, the number of mutual banks are that of the Regional Banks Ⅱ.

While the Banking Bureau was considering the conversion of banks, a formal request for conversion was submitted by the president of the National Association of Mutual Banks in May 1984. The Financial System Research Council established the Financial System Sub-Committee (see below) in September 1985 to study the issue, and compiled a report in December 1987. The report claimed that the separation of categories was less meaningful now, as the ratio of mutual installment that was once the original business of mutual banks became the lowest ever, and even ordinary banks increased loans for small and medium companies. By this report, a policy was made to allow financial institutions to convert based on the “Law concerning amalgamation and conversion of financial institutions” if they wished.

The Banking Bureau issued a notification concerning the operation of the “Law Concerning the Amalgamation and Conversion of Financial Institutions” in July 1988, and issued authorizations, one by one. Then, the number of banks that converted was 52 in February, 10 in April, 3 in August and 1 in October 1989. The two mutual banks remaining were also converted to become the “Regional Banks II”.

The management of financial institutions with problems that occurred in this period included the Heiwa Sogo Bank, Daiichi Sogo Bank, Tokuyo Sogo Bank, Saga Sogo Bank, Gifu Chuo Shinyo Kumiai and Sanyo Shinyo Kumiai: these banks were either reconstructed or merged. The worst case was the Heiwa Sogo Bank. This bank had a large bad loan, including that for the family business of the founder, and there were internal management troubles after the death of the founder. Aggressive corporate management was executed by the strong leadership of the owner but it turned out to be problematic for such a case, which was sometimes seen in mutual banks. The MOF made a severe inspection and considered a solution, while they sent advisors with the BOJ. Then, in 1986, the amalgamation with the Sumitomo Bank was authorized in 1986, as it had been prepared from an early stage, and the amalgamation was executed by October.

Regulations on Branching. Regulations on branching were eased in line with the procedure of the previous term. For instance, it included: deregulation of the location of branches in metropolitan areas (competition with branches of ordinary banks was allowed from FY1985), abolition of the regulation on the number of ATMs (FY1987) and authorization of a reverse-conversion (e.g. 3 small branches consolidated into one ordinary branch from FY 1987). Thus, although deregulation and liberalization advanced as there was a change from the regulations restraining expansion in the past, it can be said that administrative guidance remained unchanged, as new regulations were proposed in turn, because the provisions of deregulation were created every year in more detail.

As for the number of branches, only city banks had increased their branches under the deregulation policy, while the increase in the entire number was modest.

The number of branches started to decrease from 1993, after the collapse of the bubble economy. Therefore, regulations on branching lost their meaning, and restrictions on the number of branches in regions except for city banks were abolished in 1993 and for city banks in 1995. Furthermore, other regulations on the location of branches, limitations on personnel in small or automated branches and limitations on handling business for sub-branches were abolished, which led to the end of history of regulations on branching (only applications were required afterwards).

The Liberalization and Increased Flexibility of Financial Regulations. The fifth and sixth "Measures for the Liberalization and Increased Flexibility of Financial Regulations" were executed, following the previous term. The fifth (FY1985) program included authorization for establishing associate companies for investment advisory, money lending, venture capital and computer service undertakers, increase of partnership services with the securities and insurance business. The sixth (FY1986) program included: the abolition of regulations on the ceiling of dividend rates, deregulation of fund management for loan trusts, pension trusts, federation of credit co-operatives (Shinren) and agricultural co-operatives (Nōkyō) and easing of advertising regulations (abolition of voluntary rules of the Federation of Bankers Associations of Japan) etc.

The Review of the Managerial Indicators Regulations. The MOF announced its "Review of Managerial Indicators", and revised its basic notification in May 1986. The basic concept of this notification showed that regulations and administrative guidance should be minimized in the future but financial institutions should be required to check the soundness of their corporate management based on their own responsibility, by using managerial indicators as a check point because the risk increased along with liberalization.

Concrete review points were as follows: 1) the enhancement of equity capital aiming at 4% or more of the total assets (6% or more for international activities); 2) regulations on dividend payout ratio (within 40%) were to be continued from the viewpoint of increasing profit reserves, while the regulation on the ceiling of the dividend rate was to be abolished, 3) provision of two indicators including the solvency ratio (liquidity assets/liquidity debt) and the ratio of long-term management and procurement (long-term management [long term procurement + equity capital]), 4) enhancement of the regulation on large loans by including acceptances and guarantees, and loans of the associate subsidiaries of borrowers. 5) a requirement to submit a report including managed credits, off-balanced trade and managerial indicators of overseas subsidiary companies, to understand the management conditions.

Inspections of Financial Institutions. In order to prepare the inspection method, surveys were made in foreign countries every year from FY1985. The CAMEL method in the United States was then referred to in the revision of the inspection system in Japan in 1987. CAMEL stands for the following: C (Capital: enhancement of capital), A (Assets: soundness of assets), M (Management: system of management), E (Earnings: earnings performance), and L (Liquidity: liquidity). It was based on the recognition that a more multilateral risk assessment was now demanded, which paid attention to these items.

As a result of the inspections, land-related loans and loans for *zaitech* significantly increased. The defects of the management system, such as the incomplete examination of land-related loans, and organization form that examination section took into each business headquarters, were also pointed out. However, the corporate management of financial institutions was in a good state due to the background of the good conditions of the economy and the expansion of business activities and it was not necessary for the authority to issue a warning. Problems like the increase in bad loans emerged after the collapse of the bubble economy.

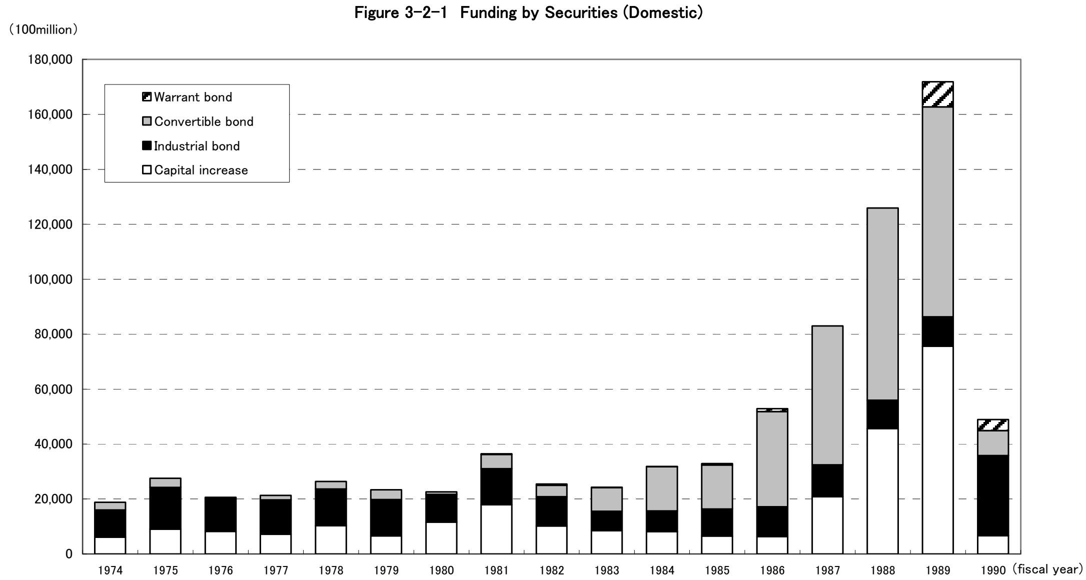
3 The Expanding Securities Market

The Bubble Economy and Black Monday. The stock market in this period, as mentioned earlier, showed an energetic expansion under the bubble economy. The Nikkei Stock Average recorded its highest price of ¥38,915 in the final session of the year on December 29, 1989. It rose suddenly and tripled in only four years, from ¥13,113 at the end of 1985. Even despite the sharp drop in the NY stock market on October 19, 1987, (Black Monday) and the worldwide depreciation of stock prices, the Japanese market recovered earlier than that of other countries.

In the boom of the stock market, the issue of securities, including warrant bonds and convertible bonds and stocks (the issue of these securities was called “equity finance”) increased significantly as shown in Figure 3-2-1. The system of corporate bonds with warrants (“warrant bonds”) was established in 1981, and the first warrant bond was issued in the same year. In the corporate finance of this period, securities issuance increased more rapidly than bank loans, therefore securities issuance exceeded as much as two-thirds of bank loans in 1988, although the bank loans also increased.

The bank loans increased mainly for real estate securities and real estate properties and funding by bond issues also increased. The internal capital of enterprises was also abundant, and those capitals were allotted to the properties investment, such as stocks and real estate, as well as for aggressive real investment. Both assets and liabilities increased at the same time, and in terms of assets, they were significantly increased in both real and financial investments. However, this turned into excess indebtedness once the assets decreased upon the collapse of the bubble economy. Therefore, balance sheet adjustment was inevitable, so that a serious and long economic stagnation was caused as a reaction from the boom (deep-rooted stagnation including financial sectors).

Figure 3-2-1 Funding by Securities (Domestic)



Source: Ministry of Finance, *Okurasho Shokenkyoku Nenpo* [Annual Report of the Securities Bureau, Ministry of Finance] 1989, 1990.

The Hollowing out of the Domestic Corporate Bond Market. Against the economic boom, the primary market of domestic corporate bonds started hollowing out. For funding by corporate bonds, offshore funding exceeded the funding in the domestic market in FY1983. The offshore funding exceeded domestic funding for overall securities including stocks in FY 1985. In the period of the bubble economy, the domestic funding increased suddenly and exceeded the foreign market, but the problems of domestic market had basically not yet been resolved.

The problems of a domestic bond market were obvious for the straight industrial bonds because their cost was higher than that of foreign market in terms of interests, commissions and swap etc., inflexible schedule and conditions of issuance and the severe standard required for unsecured bonds (the cost would be expensive for secured bonds). That is, the domestic market did not meet the needs of issuers and investors.

The Problem of the Increase in the Membership of the Tokyo Stock Exchange. With the Yen-Dollar Meeting report, the Tokyo Stock Exchange decided to increase its membership in its board of governors meeting in August 1985.

Upon selection of the candidates, ten companies were granted the membership (4 American, 2 British and 4 Japanese companies) as the primary program in December. In the secondary program, 22 companies (6 American, 4 British, 2 French, 2 German, 2 Swedish and 6 Japanese companies) were granted membership in December 1987.

Administrative Guidance. In terms of the supervision of securities companies, with the merger of the Yamaichi Securities Investment Trust Sales, Koyanagi Securities and Daifuku Securities in April 1985 (to become Taiheiyo Securities), securities investment trust sales company no longer existed. With the increasing merger of medium-sized securities companies, the number of semi-major general securities companies became noticeable.

Regulations on branching were eased by the notification in March 1986. In particular, the double procedures, once required for inner authorization before authorization was amended as the inner authorization process, were abolished. It was a big step for simplification of administrative guidance.

The performances of securities companies were sound as a whole, thanks to the vitality of the market in the bubble economy but problems hid behind the boom. Problems such as illegal transactions (scandals) and the financial difficulties of companies came to be noticed after the collapse of the bubble economy.

4 Liberalization, Internationalization, the Aging Society and Insurance

The Trend of the Insurance Market. As mentioned above, the insurance market in this period kept growing, thanks to the economic expansion in the bubble economy.

The trend of the life insurance business was as follows. There had been 20 life insurance companies for a while in the postwar era, but it became 21 after the entry of the Ryukyu Life Insurance Company in 1972. Then, American Life and American Family entered into the market in 1973 and 1974 respectively. Both companies only opened the branches to enter the market under the “Law Concerning Foreign Insurance Companies” of 1949. This was followed by Seibu All State in 1975, and Sony and Prudential in 1981 which entered into the market as joint venture. INA entered into the market as 100% foreign capital affiliated company in 1982. Then, following the precedent, foreign insurance companies began to enter into Japanese market, and therefore, the number of Japanese companies became 25 (16 mutual companies and 9 stock companies) based on the Insurance Business Law and the number of companies based on the Law Concerning Foreign Insurance Companies reached 5. Companies in total became 30 at the end of FY 1988.

There had been 22 non-life insurance companies in Japan for a long time in the postwar era, but Allstate Automobile and Fire Insurance Company (as an overseas subsidiary of Allstate Insurance Company (U.S.) by 100% foreign capital) obtained a business license based on the Insurance Business Law and entered the market and the total number of companies reached 23. There were also foreign non-life insurance companies based on the Law concerning foreign insurance companies so that the number was 37 at the end of FY 1988.

In addition, as there were also insurance services, such as mutual aid and postal life, and the insurance market tended to expand.

The Insurance Council Report's Recognition of the Era. There were two Insurance Council Reports in this period: "On the Desirable Form of the Life Insurance Business to Correspond to a New Era" in 1985, and "On the Desirable Form of the Non-life Insurance Business on entering a New Era" in 1987. Both reports summed up the trend of the financial market comprehensively that liberalization and internationalization were developing progressively, and considered its effects on insurance business, and the reports specified the measures required for insurance companies in detail.

The 1985 report related to life insurance summarized the change in the market environment as follows: the liberalization of financial market was steadily advancing under the base of the change of the growth pattern and the economic structure, due to causes such as the advanced accumulation of financial assets, the increase of government debt outstanding, the expansion of bond market, the revolution of financial technologies due to electronics and the internationalization of financial market.

It showed the necessity for life insurance companies to enhance their capability and competitiveness, because the effects of competition with other business and foreign companies would be severe. As for expansion of business activities, they should take into consideration of the importance of the principles of specialization of the insurance business, in order to prevent potential loss from doing other business. On the other hand, it stated that the expansion of affiliated business and services with affiliate companies should be positively progressed.

Moreover, it was pointed out that the progress of the aging society would be an important factor for companies to take measures such as regarding income insurance (mainly for personal and corporate pensions) and medical benefit (mainly for medical insurance), and pursuing the possibility of a contribution to meet various needs of welfare services for the elderly, such as nursing.

The 1987 report related to non-life insurance summarized the changes in the market environment, and pointed out measures to be taken as follows: financial liberalization would affect the asset management of non-life insurance companies directly, in the same manner as other investors. In this situation, effective operations of business and requirements were necessary to provide services to customers. Regarding the products and services, there would be little direct impact on business (such as competition), but profitability as financial assets was also demanded for insurance products, which was seen as a savings-type products. Meeting the customer needs, as one of the factors of financial liberalization, was also seen as required for the non-life insurance business, and therefore, non-life insurance companies were required to enhance their products and services.

Increased Flexibility regarding in the Third Sector. The 1985 report stated that as for the third sector across the life insurance and non-life insurance businesses, “it would be necessary to study about the promotion of flexible management,” in order to meet the increasing needs and to fulfill provision of insurance products, such as bodily injury insurance, and sickness-related insurance, with the progress of the aging society.

In 1980s, insurance companies were facing the final stage of the postwar era and the predawn of the new era, as shown in Chapter 1. The new era, in which the market faced real competition and companies were required to confirm their own corporate management policy, came in the 1990s.

5 Examination of a “New Financial System”

The Progress of Discussions. To examine the desirable form of the financial system from the basics, the Financial System Research Council decided to establish a Financial System sub-committee in September 1985. In the six years to come (all periods of the bubble economy were consequentially covered) issues were discussed, in the Financial System Sub-committee and in the first and second subcommittee, regarding a financial system. Finally, the Financial System Research Council submitted its report “On a New Financial System” in June 1991. The “Package Law for the Comprehensive Review of the Financial System” based on this report was promulgated in June 1992, and enforced on April 1, 1993. This was a step toward the drastic reform of the financial system, to be made through the mutual entry method, by establishing separated subsidiaries.

The Report of the Financial System Subcommittee. The Financial System sub-committee summarized its report “On the Desirable Form of a Specialized Financial Institutions System” in December 1987. This report was a summary of the major issues that needed to be considered, and stated the following:

○ It is necessary to examine the separation of financial systems from the viewpoint of efficiency, fairness, and the even quality of technology and globalization

○ The difference between "wholesale" and "retail" should be considered in the review of the financial system, because efficiency and self-responsibility are is important for the former, and safety is important for the latter.

○ While there are merits and demerits to universal banking, consideration would be necessary as to whether banks, which are required to be sound in management may enter the high risk securities market.

○ While "Economies of scope" are also effective for the financial market, it is necessary to consider issues, such as conflicts of interest and the soundness of business.

○ As for preventing conflicts of interest, there were such views as: 1) it will be prevented by competition; 2) it is necessary to use a fire wall (Chinese Wall); 3) it is necessary to separate into different companies; and 4) it is necessary to prohibit by-business. However, 1) and 4) would be difficult to adopt, and 2) would still be insufficient to solve all the problems.

Interim and Final Reports. With the above-mentioned report, the Council established the First Subcommittee (for small and medium-sized financial institutions) and the second Subcommittee (for others) to discuss financial system, and began discussions from February 1988.

The First Sub Committee reported that regional financial institutions played a role to provide services to meet the needs of regions, and financial institutions as a form of joint organization would be as necessary in the future as ever.

On the other hand, the Second Sub-Committee submitted its first interim report, "On a New Financial System", in May 1989. The points of this report are as follows:

○ At present a separation system of activities has been made for the smooth allocation of chronically short funds to various industrial sectors through specialized institutions. However, the time has come to review the system, in line with the changing environment.

○ The main perspective of the review is the convenience or profit of users, internationalization, the maintenance of the order and fairness in financial systems.

○ There are five measures to review specifically (Figure 3-2-2):

A: The Mutual entry method

B: The Method of separated subsidiaries

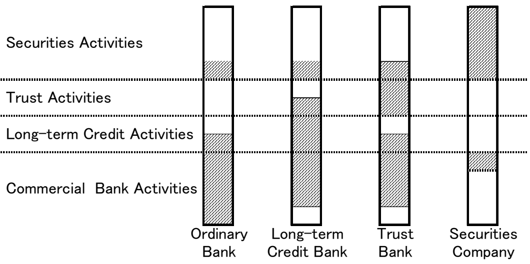
C: The Special Case Law method (a special institution allowed to have by-functions of various financial services – called an "investment bank plan" – would be established by each financial institution as 100% subsidiary company)

D: The Holding company method

E: The Universal Bank method

Figure 3-2-2 The Five Systems Envisaged for the Review of the Financial System

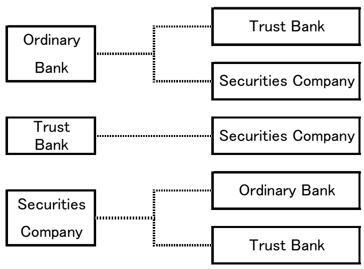
A. Mutual Entry



◇ The current business activities are as shown in the figure in general. Financial institutions proceed mutual entry in consideration of the current business activities.

[▨ is current activities]

B. Separated Subsidiaries per Business Pattern

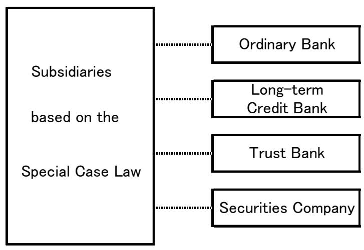


◇ In consideration of the current business activities, financial institutions proceed mutual entry by wholly–owned subsidiaries

e.g. Canada

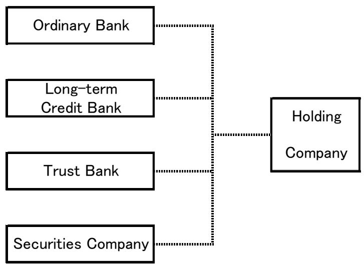
[Same for Long-term Credit Bank]

C. Special Case Law



◇ Financial institutions establish a new wholly–owned subsidiaries which can engage in banking activities (including issuing bank debentures), trust activities and securities activities within the certain limitation of each business (e.g. limited to wholesale finance).

D. Holding Company

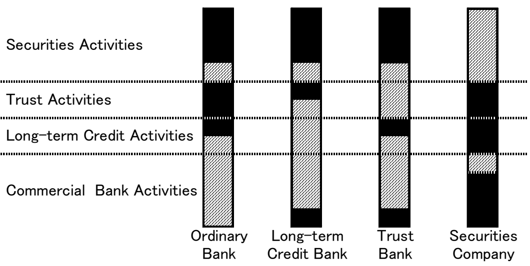


◇ In consideration of the current business activities, financial institutions proceed mutual entry through subsidiaries of holding companies

e.g. U.S. Proxmire Financial Modernization Act

[Same for Long-term Credit Bank]

E. Universal Bank



◇ Financial institutions (in the present organizational form) cover all the business activities

e.g. EC countries (such as West Germany, France, U.K.) , Switzerland etc.

[■ is newly allowed activities]

Source : Institute for Financial System, *Atarashii Kinyu Seido Ni Tsuite – Kinyu Seido Chōsakai Toshin* [On A New Financial System – Report of the Financial System Research Council] p502(1991, Institute for Financial Affairs)

Note : Foreign Exchange Bank is included in Long–term credit bank in this figure as it is allowed to issue bank debentures.

The mutual entry method was too partial. The holding company method could be effective to prevent conflicts of interest, but there would be problem of dominant power like *zaibatsu* in the era before the World War II. The Universal Bank method was excellent in terms of efficiency but there were problems concerning the soundness of banks and conflicts of interest. In the end, it was decided that the method of separated subsidiaries per business pattern and the Special case Law method should be mainly considered.

The First Sub committee advanced the examination further, and prepared the second interim report “On a New Financial System” in July 1990. It concluded that the method of separated subsidiaries would be preferred in terms of credibility, prevention of conflicts of interest, fairness of competing conditions, and user benefit and convenience.

The final report “On a New Financial System” of the Financial System Research Council was submitted on June 25, 1991. In the same month, the report “How the Basic System for Capital Market ought to be reformed” was submitted by the Securities and Exchange Council. The Package Law for the comprehensive review of the Financial System was promulgated in June 1992, and enforced on April 1, 1993, to implement a drastic reform of the financial system through the mutual entry method.

The establishment of the separated subsidiaries was advanced, starting with the securities subsidiary established by long-term credit banks in July 1993. However, the management of financial institutions was weakened due to the collapse of the bubble economy, and there was a spreading sense of crisis that Japanese financial market would lose its competitiveness. In this circumstance, the “Japanese Big Bang” policy was applied to enact the Financial Holding Company Law (enforced in March 1998), the revised Foreign Exchange Control Law (April 1998) and the Financial System Reform Law (December 1998). Therefore, the large-scale reconstruction of financial industries significantly progressed, mainly using the holding company method.